MACROECONOMIC STABILIZATION AND EXCHANGE-RATE REGIMES: ALTERNATIVE SCENARIOS[†]

Why Did the Ruble Collapse in August 1998?

By PADMA DESAI*

On 17 August 1998, the Russian government was forced by an escalating payments crisis to devalue the ruble, default on its domestic debt, and declare a moratorium on payment by Russian commercial banks to foreign creditors. As a result of this meltdown, inflation control, a stable ruble, and a fragile turnaround of GDP growth visible toward the end of 1997 came to a halt.

In this paper, I analyze the factors that led to the collapse of the ruble, arguing that it resulted from exogenous factors (closely related to the unanticipated Asian financial crisis) interacting with inherited weaknesses in fundamentals (of fiscal policy) that made the Russian economy, while progressively being brought to macroeconomic stability, nonetheless vulnerable to a large external shock. I contend that, instead of the policy mistake of August 1998 requiring a default of domestic debt and moratorium on payment of foreign commercial debt, a decision by Russian authorities to opt for temporary exchange controls, sanctioned by the IMF and the U.S. Treasury as an emergency measure, would have been a better alternative, obviating the de facto partial and unilateral resort to controls that the moratorium and default implied.

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I. The Policy Framework: July 1992–August 1998

Macroeconomic stabilization policies during the period, aimed at eventually reviving the economy under a stable inflation regime, were marked by monetary-control and fiscal mismanagement. As shown in Figure 1, inflation, measured in terms of change in the consumer price index, was brought down to less than 1 percent per month by September 1997 via a sustained slowing down of money-supply growth rates from quarter to quarter, shown in Figure 2.

Nonetheless, budgetary management continued to be shaky. The federal budget deficit (shown in Fig. 3) remained high, in the range of 7–8 percent of GDP during most of 1996–1997. Two ominous structural features marked this performance. The revenues of the federal government (shown in Fig. 4) declined from 12 percent of GDP at their highest point in December 1997 to a little over 10 percent in the months prior to the meltdown. More to the point, monthly interest payments from the budget (shown in Fig. 5), 23 percent of the revenues in January 1998, had jumped to a whopping 51 percent in July 1998.

The fiscal health of the federal government was more critical than was suggested by these numbers. The government struggled to contain the deficit by diverting cash from off-budget funds, among them the Pension Fund. It also failed to enforce timely wage payment to budget-sector employees from federal funds to be disbursed by local administrations.

In short, the IMF-led policy agenda of unsustainable inflation control to low single-digit rates by the end of 1997 lacked fiscal consolidation, which would have required consensus between the reformist government and the intransigent Communist-led lawmakers in the

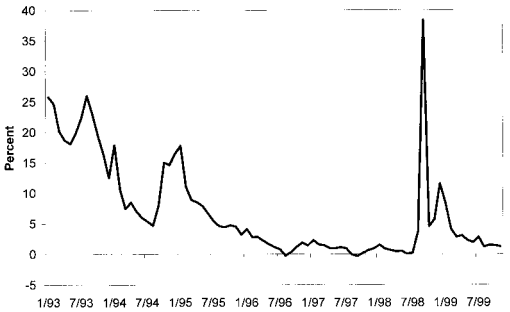

FIGURE 1. INFLATION RATE: MONTHLY PERCENTAGE CHANGE IN CONSUMER PRICES, JANUARY 1993–NOVEMBER 1999

Source: Russian Economic Trends.

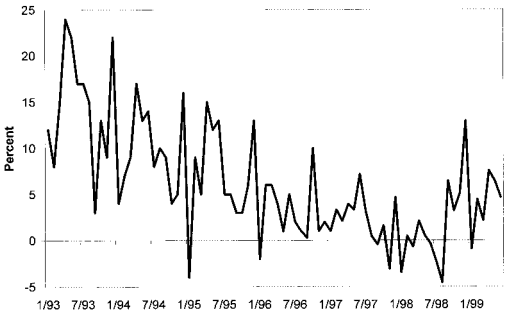

FIGURE 2. GROWTH RATE OF THE MONEY SUPPLY: MONTHLY PERCENTAGE CHANGE IN MONEY SUPPLY, JANUARY 1993–JUNE 1999

Source: Russian Economic Trends.

FIGURE 3. FEDERAL BUDGET DEFICIT AS A PERCENTAGE OF GDP, DECEMBER 1993–JUNE 1999

Notes: Annual data, December 1993–December 1995; monthly data, January 1996–September 1998; quarterly data, December 1998–June 1999.
Source: Russian Economic Trends.

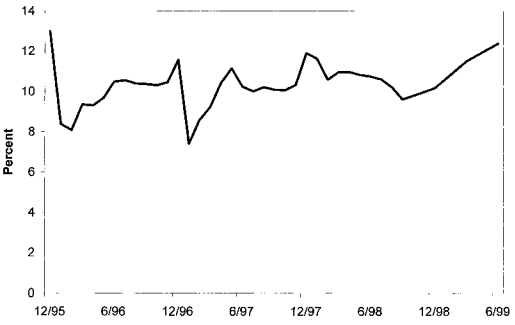

FIGURE 4. FEDERAL REVENUES AS A PERCENTAGE OF GDP, JANUARY 1996–JUNE 1999 (IMF DEFINITION OF REVENUES)

Source: Russian Economic Trends.

Duma (the lower house of the parliament) on issues ranging from the adoption of a tax code and tax rates to their effective implementation. Unable to raise adequate taxes and prohibited by the IMF from borrowing from the Central Bank of Russia in 1995, the government relied on the market to pick up government short-term bills (GKO's) and long-term bonds (OFZ's), in the process attracting short-term foreign funds in excess of foreign-exchange resources available to finance their sudden withdrawal.

At their lowest levels in the final quarter of 1997, the annualized yields on government securities averaged 25–30 percent, far higher than comparable rates abroad. The restrictions on foreign capital flows seeking to profit from these differentials were removed: this was a colossal mistake. Thus, in 1997, the earlier requirement limiting purchases of government securities to *domestic* investors was lifted, allowing foreign speculators easy access. In November 1997, nonresident holders of GKO's signed forward contracts with the Central Bank of Russia in anticipation of a decline in the ruble following the collapse of Asian currencies. Not to be left out from gainful speculative transactions in government securities, Russian banks borrowed heavily in foreign markets, registering a rise in their foreign liabilities as a proportion of assets (mostly in domestic government securities that were to become worthless) from 7 percent in 1994 to 17 percent in 1997.

II. Exogenous Shocks to Ruble Stability

The Russian situation in terms of fundamentals was therefore marked by poor fiscal

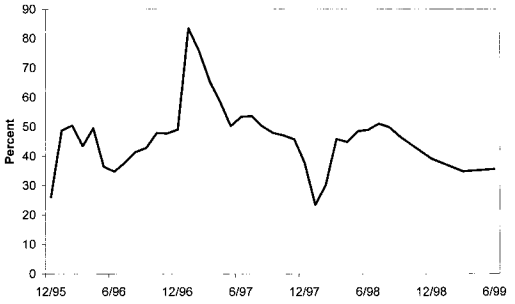

FIGURE 5. DEBT BURDEN: FEDERAL-BUDGET INTEREST OUTLAYS AS A PERCENTAGE OF FEDERAL REVENUES (IMF DEFINITION OF REVENUES)

Source: Russian Economic Trends.

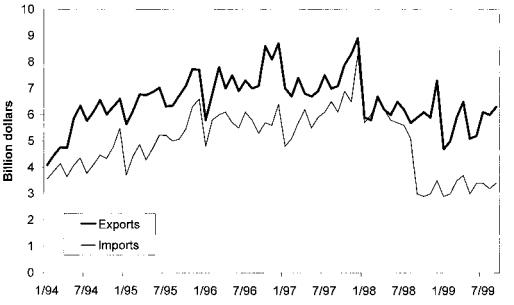

FIGURE 6. EXPORTS AND IMPORTS, JANUARY 1994–SEPTEMBER 1999 (MONTHLY FIGURES)

Source: Russian Economic Trends.

management, with inflation constrained largely by a firmer monetary policy combined with external borrowing that was sufficiently large to raise the prospect of panic-driven outflows. Such outflows would not be confined to short-term external borrowing, but would also affect domestically held rubles that could be converted into dollars because of de facto capital-account convertibility. The stage was thus set for an impending financial crisis spilling into a currency crisis in the event of external shocks to Russia's balance of payments. In the formal analysis of Paul Krugman (1979, 1998), the Russian malaise combined elements of the first- and third-generation currency-crisis models: Russian policymakers' attempts to maintain a stable ruble in the midst of a government-borrowing-financed budget deficit were overwhelmed by plummeting values of government GKO's as external shocks hit Russia's balance of payments.

These shocks came about from two exogenous factors: the collapse of the East Asian currencies starting in mid-1997 and the decline in oil and nonferrous metal prices that began in December.

The decline in oil prices from $23 per barrel in mid-1997 to $11 per barrel a year later, accompanied by falling prices of nonferrous metals, hit Russian foreign-exchange earnings from two major exports, affecting its trade balance. According to Sergey Alexashenko (1999 p. 3), the trade balance (shown in Fig. 6) shrank to $2.4 billion in the first half of 1998 compared to its average range of $10–11 billion in the first half of the preceding three years. Combined with soaring interest costs of foreign borrowing, the current-account balance turned negative in the amount of $5 billion for the first half of 1998, in contrast to positive amounts of $4–6 billion in the first half of the preceding three years.

The flight of nonresidents from government GKO's and the ruble could not be stopped despite a hike of the central bank interest rate to 150 percent in June 1998. The first installment of $4.8 billion of the IMF assistance package of $22 billion announced in July in support of the currency disappeared in two weeks. As noted by Alexashenko (1999 p. 5), the substantial purchases of foreign exchange by households across Russia's major cities depressed the ruble by 10–15 percent in mid-August. The crisis marked by the inability of the government to redeem the GKO's held by foreigners and of the Russian banks to pay their foreign creditors called for drastic measures.

III. Government Debt Default and Commercial Bank Debt Moratorium

In early August, the foreign-exchange resources available to the government (after the disappearance of the IMF funding of $4.8 billion) fell short of its ability to redeem the foreign share of the GKO-OFZ securities that fell due by December 1998 and the foreign debt of Russian commercial banks. The former was approximately $6 billion, and the latter $16 billion, of which the critical part of $6 billion was in the form of forward currency contracts with nonresident investors in GKO's.

The foreign-exchange liabilities of Russian banks threatened to destroy their balance sheets. As with banks and financial institutions in East Asia, their debts, mostly short-term of 6–9-month duration, were backed by fast depreciating government securities and had cross-default clauses holding a bank responsible for the debt default of another bank. Facing substantial margin calls and refusal of creditors to roll over their liabilities, Russian banks bought foreign exchange to repay debts, in the process drying up their liquidity and creating interbank loan defaults.

The gross foreign-exchange reserves (excluding gold) held by the central bank for clearing the total short-term obligations noted above (not counting public demand for dollars) averaged $10 billion. At the same time, sources of external financing had dried up. With eurobond spreads exceeding 700 points, the Ministry of Finance could not borrow abroad nor could the government find investors to buy its stake in privatized companies.

The government could borrow directly from the Central Bank of Russia after getting the legal authorization from the Duma, start a deluge of currency emission, and wreck macroeconomic stability, or mandate a nonvoluntary restructuring of the short-term debt. It opted for the last course.

The measures implied a default by the government on its GKO debt and a 90-day moratorium, agreed to by the IMF, on foreign-debt payment by Russian banks. According to details provided in Alexashenko (1999 p. 7), the original GKO-debt restructuring plan had a dual approach allowing conversion of foreign-held GKO's into dollar-denominated securities with no immediate cash payment, and allowing 20–25-percent cash payment to resident holders, mostly banks, to bolster their liquidity. Having initially agreed to this unequal-treatment approach, the IMF changed its position, evidently under pressure from the U.S. Treasury. The final plan, allowing 20-percent cash payment to all investors, imposed a higher burden on the Russian budget, forcing it to generate the cash via inflationary means.

IV. Was Ruble Devaluation a Desirable Option?

Could Russia's policymakers have avoided these drastic measures if they had abandoned defending the currency and devalued it in time? The protagonists of devaluation, summarized in Vladimir Popov (1999), argued that the ruble was overvalued in real terms and that the Central Bank of Russia mistakenly stuck to its policy of defending the ruble band despite losing massive foreign-exchange reserves.

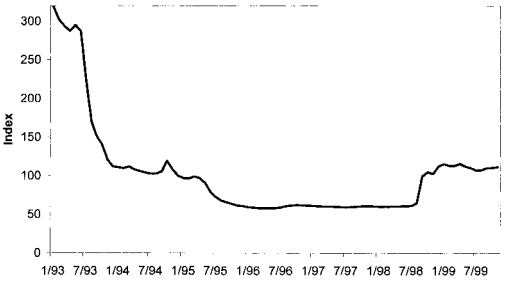

FIGURE 7. REAL EXCHANGE RATE OF THE RUBLE

Notes: The figure shows the real exchange rate, period average from January 1993 to November 1999 (December 1994 = 100). The rate is a trade-weighted exchange rate. A decline in the series represents an appreciation. The trade weights are 40 percent for the United States, 40 percent for Germany, and 20 percent for Ukraine.
Source: Russian Economic Trends.

The substantial 1993–1994 real appreciation of the ruble (shown in Fig. 7) under a managed-float regime was designed to rein in inflation from 2000-plus percent in 1992 to a double-digit 95 percent in 1995. The nominal exchange rate of the ruble was allowed to depreciate at a lower rate than the inflation-rate differential between the Russian and U.S. economies. This exchange-rate regime, tilted in the direction of inflation control at the expense of maintaining the competitiveness of Russian tradables, also bridged the gap between the highly depreciated ruble following the massive currency emission of 1992 and its purchasing-power-parity rate as noted in Desai (1998). The policy stance was moderated subsequently: the real exchange rate in Figure 7 remained constant under a shifting nominal ruble band regime according to details provided in Desai (1997). When the ruble came under attack in November 1997 and June 1998, the government, in the view of Alexashenko (1999 p. 12), considered letting the ruble float but chose instead to defend the band, losing $6 billion and $5 billion, respectively, in the process.

Could the government have avoided the catastrophe if it had settled for a 15–20-percent devaluation in, say, mid-November, 1997? I agree with Alexashenko that, while marginally improving the competitiveness of Russian goods, it would have pushed up the ruble cost in the budget of servicing Russia's foreign debt and compelled nonresidents to sell their GKO's right away, adding to loss of confidence in the currency and destabilizing it further.

More critically, Russia's policymakers did not manage to get financial support from the IMF, despite repeated requests in November 1997 and February–March 1998. It came late and too little in July in the amount of only $4.8 billion. Through the crisis months, Russia's treasury, short of cash, sought and failed to raise cash at home and abroad. At the same time, Russian politics continued to be volatile. The president sacked Prime Minister Chernomyrdin in March in the midst of financial turmoil. The Duma merrily debated the confirmation of the new appointee, Sergei Kiriyenko, for a full month in April. Having confirmed his appointment under the threat of a parliamentary dissolution by the president, it turned down his austerity budget in July.

V. Restoring Exchange Controls, Russian Style

Ultimately, therefore, the policymakers turned to debt default and moratorium, in fact overturning the de facto convertibility of the earlier period. With a devaluation inappropriate, with inadequate external support from the IMF (unlike in the case of Brazil which had poor fundamentals and a similar exogenously driven crisis), and with no assistance from other sources, Russian authorities were left without an option.

The 90-day moratorium legally exempted Russian banks from clearing their margin calls and forward contracts. The Central Bank of Russia was allowed by law to ban these transactions. In the process, it damaged the economy's credit rating and future borrowing potential.

The question must then be raised: was a better option not available, even if the IMF could not bring itself to increase its assistance above $4.8 billion? I would argue that Russia did have the choice of adopting temporary exchange controls as an emergency measure with IMF and U.S. Treasury sanction. This would have been less damaging than the de facto partial and unilateral moratorium and default.

Unfortunately, the IMF and the U.S. Treasury could not accept that option at the time, having drawn a firm line against capital-account controls as a response to the crises sweeping several East Asian economies after the collapse of the Thai baht in mid-1997. Recently that opposition has softened, and the rationale for such controls under certain conditions has been widely conceded. The new wisdom, however, came too late for Russia.

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